

# Transaction Cost Economics and Organization Theory

**Oliver E. Williamson**

“The Economics of Organization Design” is a vast literature. The relation between economics and organization theory is minimal for parts of it.

My focus is on the relation between transaction cost economics and organization theory – which I describe as a two-way street. Conjecture: but for my interdisciplinary training at Carnegie, I have grave doubts that I would ever have become involved with the study of firm and market organization from a transaction cost economics perspective -- which is to say that my debts to organization theory are massive.

- I. **The Inroad Street:** Contributions from organization theory with which (many) transaction cost economists concur.
  1. Organization matters and is susceptible to analysis.
  2. Opening the black box of firm and market organization and examining the mechanisms inside with reference to adaptation is vital to an understanding of firm and market organization.
  3. “Nothing is more fundamental in setting our research agenda and informing our research methods than our view of the human beings whose behavior we are studying” (Simon, 1985), of which bounded rationality is one.

4. Calculativeness is instructive but, as with all good things, can be overdone. Many maxims of economics are over-reaching.
5. Organization has a life of its own, the key regularities of which need to be identified, the mechanisms uncovered, and the ramifications worked out.
6. The action in the study of complex economic organization is in the details, which proliferate. The use of focused lenses (plural) is vital.
7. Alternative modes of organization differ in discrete structural ways, to include provision for the institutional environment.

- II. The Backroad Street:** uses of the foregoing by TCE, with which (some) organization theorists concur.
1. Organization matters, of which economizing on transaction costs is one of the leading purposes served by complex economic organization.
  2. Opening the black box of firm and market organization and examining the mechanisms inside with reference to adaptation is usefully accomplished by regarding firm and market as alternative modes of governance (which is a comparative contractual construction). Adaptations of autonomous and coordinated kinds are distinguished in this connection. (Organizational design ramifications accrue, as sketched in III.)

3. The cognitive and self-interest attributes of human actors are important. Bounds on rationality preclude comprehensive contracting but do not preclude forward thinking design efforts (cf. R. Michels on oligarchy). Self-interest is also described in a two-part way: benign behavior (cooperation) for small disturbances; strategic behavior (defection from the spirit of cooperation) for outliers where the stakes are great. This has organizational design ramifications. Credible commitments are introduced in cost effective degree to mitigate defection, thereby selectively to extend the range of cooperation. Credible commitment is a hard-headed but user-friendly concept (contrast: open-ended appeal to “trust”).

4. Textbook maxims are often instructive, but beware over-uses by the “true believers” and misrepresentations by “disbelievers.” Examples:

- Never leave any money on the table.  
    Contrast: Investment banker: Always leave ...
- Hypothetical ideals have a place  
    e.g., “costless bargaining”  
    but need to be kept in their place when real world phenomena come under review.

5. Intertemporal transformations have profound design ramifications – both within firms (to include bureaucratization) and for interfirm contracting between firms (especially the Fundamental Transformation). This goldmine is underworked

6. Examining economic organization through the focused lens of contract/governance with reference to the Commons Triple (of conflict, mutuality, and order) is instructive. Governance is the means by which to infuse order, thereby to mitigate conflict and realize mutual gain – which has pervasive design ramifications and is congruent with the proposition that “mutuality of advantage from voluntary exchange ... is the most fundamental of all understandings in economics” (Buchanan, 2001).
7. The institutional environment is unarguably important but needs to be given operational content if the ramifications for governance are to be worked out (example Positive Political Theory).

### III. Dimensionalizing Governance: Viable and Non-viable Modes

#### 1. Governance attributes

- incentive intensity
- administrative control
- contract law regime

Two values: much (+) and little (0)

$2^3 = 8$  combinations

	Incentive intensity	Administrative control	Contract law regime
I	+	+	+
II	+	+	0
III	+	0	+
IV	+	0	0
V	0	+	+
VI	0	+	0
VII	0	0	+
VIII	0	0	0

A word about contract law regime:

(+) denotes legal rules (court ordering)

(0) denotes forbearance (private ordering)

## 2. Criteria

- (1) Modes where incentive intensity and administrative control are both nil are irrelevant to commercial transactions.
- (2) Elsewhere, incentive intensity and administrative control should take on opposite values (high powered incentives are compromised by administrative control and vice versa).
- (3) The appropriate contract law regime is supportive of the incentive/control attribute with the (+) value.

### 3. Application

Criteria (1) and (2) eliminate I, II, VII, VIII

Criterion (3) eliminates IV and V

Viable modes (adaptive advantage)

III:market (autonomous)

VI:hierarchy (coordinated)

#### **IV. Research Needs and Opportunities, all with respect to “What is going on here?”**

1. Disequilibrium Contracting  
(real time responsiveness)
2. Entrepreneurship (and finance)
3. Human Capital Firms
4. Noncommercial Enterprise
5. Nonstandard Contracting  
(in all of its forms)
6. Organizational regularities
7. Bureaucratization
8. Full formalism; empirical testing